Fidelity Investments®

Statement for the Record

on

"Rating the Rating Agencies: the State of Transparency and Competition"

before the

United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

April 2, 2003

Introduction

Fidelity Investments commends Chairman Baker, Ranking Member Kanjorski and other distinguished Members of the Subcommittee for their review of the role of rating agencies in the U.S. securities markets. We are pleased to have this opportunity to address the state of transparency and competition in the industry.

Fidelity Investments is one of the world's largest providers of financial services, with managed assets of $755.4 billion as of February 28, 2003. Fidelity offers investment management, retirement planning, brokerage, human resources and benefits outsourcing services to 18 million individuals and institutions as well as through 5,500 financial intermediaries. The firm is the largest mutual fund company in the United States and the No. 1 provider of workplace retirement savings plans in the country. Fidelity employs more than 28,000 people in various locations throughout the United States.

Through its fixed income division, Fidelity manages approximately $ 370 billion in bond, money market and other fixed income accounts, of which approximately $230 billion is invested in money market mutual funds. In such capacity, Fidelity is both a consumer and a recipient of credit ratings. When considering what debt obligations to purchase or sell on behalf of the mutual funds, Fidelity analysts review ratings from the national recognized statistical rating organizations (NRSROs). In addition, given the needs of certain purchasers of mutual funds, a number of our fixed income funds are regularly evaluated by the NRSROs and receive credit ratings. Accordingly, we are acutely aware of the increasing influence of NRSRO ratings and understand both their value and limitations in the investment decision-making process.

Maintaining the quality and integrity of credit ratings requires regulatory oversight

Fidelity believes that the NRSROs serve a valuable role in providing regulatory benchmarks and as peer credit analysts. However, we also recognize, given their increasing influence in the markets, certain areas for improvement.

For nearly a century, rating agencies have examined issuers of debt and published opinions as to the likelihood of the debt being paid on time. In recent years, NRSROs have achieved greater influence in the financial markets. This greater influence resulted in part from the increased use of the NRSRO concept in legislation and regulation. For example, SEC rules set minimal credit quality standards for the approximately $2.3 trillion in money market mutual fund assets. These rules employ the NRSRO rating as a benchmark for such credit quality standards. In addition, with the growth in investment grade bond funds, prospectuses can also use the NRSRO concept as a benchmark for credit quality. As a result, when an NRSRO lowers a credit rating of an issuer or instrument, regulatory requirements to either sell or decrease a position can follow.

Given the growing reliance by the securities markets and regulators on NRSROs, Fidelity recommends increased SEC oversight through a biennial or triennial NRSRO review process in which public comment and participation is solicited. Fidelity suggests that the SEC seek the views of key participants in the fixed income markets from which NRSROs gain their influence, but a minority of their revenue. Such forums would address weak spots such as deterioration in ratings quality, poor transparency, and potential conflicts as the rating agencies expand their business models. These public forums would help to highlight best practices and identify threats to the integrity of ratings early on. In addition, Fidelity recommends that the review process would result in the SEC requiring weak rating agencies to apply for re-certification of their NRSRO status, a more in depth and rigorous inspection process.

The rating agency processes are not broken

The NRSROs have done an effective job over the years, particularly given the increasing complexity in financial analysis. We have a great deal of respect for their work from our role as active consumers of their analysis, as peer analysts, and as participants in markets heavily affected by their ratings and commentary. As many have observed, there are areas of weakness, which surfaced in the recent market turmoil. Increased oversight is merited to safeguard a system that is not broken but strained. Areas of concern are subtle ones: reduced level of transparency, straying from established rating criteria, and expansion of business models that could create conflicts.

Increased oversight of rating agencies is merited

Fidelity recommends that the SEC review NRSROs on a biennial or triennial basis through written comment and public forums to solicit feed back from active fixed income market participants. The subject for comment would be various risk areas inherent in a system with few participants, large influence on the markets, for-profit business models despite quasi-regulatory roles, and business models reliant on issuers for payment of fees and not investors. Such forums could keep the SEC informed on ever more complex fixed income market developments and areas requiring greater scrutiny before serious problems arise.

It would be an effective way to provide a voice to investors heavily affected by NRSRO actions, but with little influence on their procedures and practices however detrimental. Moreover, Fidelity recommends that the SEC require weak rating agencies, which fail to meet established standards to apply for re-certification of their NRSRO status.

Risk areas to address in public comment and forums

Rating criteria –Are they appropriate? Are they up to date? Are they adhered to? Is the level of due diligence appropriately disclosed? Changing ratings in ways that surprise the market (inconsistent criteria, based on changed criteria not otherwise communicated, not well explained) add market volatility and can speed liquidity crises for companies.

Transparency – Are the rating criteria and individual rationales communicated on a timely and effective basis to the public? Has the agency kept its published methodologies and standards current as its practices evolve? Have the NRSROs clearly disclosed areas where they have reduced their due diligence or do investors presume certain levels of research the agencies have forgone?

Conflicts in business models – Several agencies have considered selling computer models that will help predict future movements in bond prices. We believe that this is a conflict, since the credit ratings they publish in part drive changing prices. They are also covering more sectors, with fewer analysts or with less rigor, eroding the quality of their ratings process.

Increased competition requires rigorous standards

We recommend that the SEC establish an NRSRO certification process for rating agencies seeking the NRSRO designation. This certification process should be modeled on existing SEC standards of designation as well as industry best practices. This should include both SEC review and a public comment process. This comment process should mirror the biennial or triennial NRSRO review, with fixed income market participants sharing in the discussion. Given the complexity of credit analysis and the need to cover a relatively large number of issuers well to maintain a meaningful rating system, rating agencies seeking the designed NRSRO status must establish a track record of quality analysis and clear communications over a period of time, including at least one business cycle. Weak competitors would reduce the reputation of the NRSRO status and cause market confusion. Competitors with less rigorous processes could also lead to ratings shopping by issuers, where weaker issuers would seek a higher rating from a competitor with lower standards. This could drive established agencies to loosen their criteria. Agencies must also be allowed to earn a decent return on the basic ratings business, to fund the increasingly expensive task of analyzing companies well and communicating their views effectively.

Conclusion

Credit rating agencies wield increasing influence over participants in and regulators of our nation’s securities markets. Laws and regulations have endowed the ratings issued by a few rating agencies, the NRSROs, with special authority as benchmarks for minimal credit quality. New entrants are eager to gain the NRSRO status. Accordingly, Fidelity recommends that both existing NRSROs and rating agencies seeking to gain the NRSRO designation be subject to a biennial or triennial review, led by the SEC with input from market participants. We also suggest that both new entrants and existing NRSROs with weak standards be required to obtain certification or re-certification of their NRSRO status.